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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., ET AL.,
Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Eighth Circuit

BRIEF FOR FORMER SEC COMMISSIONERS AND OFFICIALS AND LAW AND FINANCE PROFESSORS AS *AMICI CURIAE* SUPPORTING RESPONDENTS

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TABLE OF CONTENTS

Page

INTEREST OF *AMICI CURIAE* 1

INTRODUCTION AND SUMMARY OF ARGUMENT 4

ARGUMENT 8

I. The Text And Structure Of The Exchange Act Preclude Imposition Of Scheme Liability In Private Rule 10b-5 Actions 8

A. Scheme Liability Is Inconsistent With Section 10(b), As Construed In *Central Bank* 9

B. No Express Private Right Of Action Recognizes Scheme Liability 13

II. The Policy Arguments Advanced By Petitioner And Its *Amici* Do Not Justify Deviation From The Text And Structure Of The Exchange Act 14

A. Compensation 14

B. Deterrence 18

III. Creating A Private Right Of Action Is A Job For Congress, Not This Court 24

CONCLUSION 28

TABLE OF AUTHORITIES

Page(s)

Cases

Affiliated Ute Citizens v. *United States*,
406 U.S. 128 (1972) 10

Alexander v. *Sandoval*,
532 U.S. 275 (2001) 24, 25

Anixter v. *Home-Stake Prods. Co.*,
77 F.3d 1215 (10th Cir. 1996) 26

Basic Inc. v. *Levinson*,
485 U.S. 224 (1988) 10

Blue Chip Stamps v. *Manor Drug Stores*,
421 U.S. 723 (1975) 14

Central Bank of Denver, N.A. v. *First Interstate Bank of Denver, N.A.*,
511 U.S. 164 (1994) ..... *passim*

In re Charter Commc'ns, Inc. Sec. Litig.,
443 F.3d 987 (8th Cir. 2006) 4, 27

Chiarella v. *United States*, 445 U.S. 222, 233
(1980) 11

Credit Suisse Secs. (USA) LLC v. *Billing*,
127 S. Ct. 2383 (2007) 24, 27

Dura Pharms., Inc. v. *Broudo*,
544 U.S. 336 (2005) 10, 13

In re Fannie Mae Sec. Litig.,
MDL No. 1688 (D.D.C.) 23

Fidel v. *Farley*,
392 F.3d 220 (6th Cir. 2004) 26

First Interstate Bank of Denver, N.A. v. *Pring*,
969 F.2d 891 (10th Cir. 1992) 9

In re Lernout & Hauspie Sec. Litig.,
236 F. Supp. 2d 161 (D. Mass. 2003) 21

Mahonia Ltd. v. *JP Morgan Chase Bank*,
2004 WL 1808816 (Q.B.D. (Comm. Ct.))
(Aug. 3, 2004) 22

In re Parmalat Sec. Litig.,
376 F. Supp. 2d 472 (S.D.N.Y. 2005) 21

Radzanower v. *Touche Ross & Co.*,
426 U.S. 148 (1976) 27

Regents of the Univ. of Cal. v. *Credit Suisse
First Boston (USA), Inc.*,
482 F.3d 372 (5th Cir. 2007),
petition for cert. filed (Apr. 5, 2007) 26

SEC v. *J.P. Morgan Chase & Co.*,
No. H-03-28-77 (S.D. Tex.) 21

Simpson v. *AOL Time Warner, Inc.*,
452 F.3d 1040 (9th Cir. 2006), *petition for
cert. filed* (Oct. 19, 2006) 21

Simpson v. *AOL Time Warner, Inc.*,
No. 04-55665 (9th Cir. Oct. 22, 2004) 20

Tellabs, Inc. v. *Makor Issues & Rights, Ltd.*,
No. 06-484, 551 U.S. __ (June 21, 2007).....25, 27

Transamerica Mortgage Advisors v. *Lewis*,
444 U.S. 11 (1979).....24

Wright v. *Ernst & Young LLP*,
152 F.3d 169 (2d Cir. 1998).....26

Ziemba v. *Cascade Int'l, Inc.*,
256 F.3d 1194 (11th Cir. 2001).....26

Statutes, Regulations, and Legislative History

15 U.S.C. § 78j.....4

15 U.S.C. § 78t.....4, 11, 12

15 U.S.C. § 7241.....19

15 U.S.C. § 7246.....18

18 U.S.C. § 2.....17

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17 C.F.R. § 240.10b-5.....4

17 C.F.R. §§ 201.1100-201.1106.....18

148 Cong. Rec. S6584 (daily ed. July 10, 2002).....12

H.R. Rep. No. 107-414 (2002).....12

Hearing: A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission Before the House Comm. on Financial Services, 110th Cong., 1st Session (June 26, 2007) 18

S. Rep. No. 104-98 (1995) 12, 25

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Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80 (1981) 11

Joseph A. Grundfest, *Scheme Liability: A Question for Congress, Not for the Courts*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005524 ..... 22, 25, 27

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INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (2006) 15, 19, 20

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A.C. Pritchard, *Who Cares?*, 80 WASH. U. L.Q. 883 (2002) 17

Larry E. Ribstein, *Dabit, Preemption and Choice of Law*, 2006 CATO SUPREME COURT REVIEW 141 16

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INTEREST OF *AMICI CURIAE*[*]

Amici curiae include a bipartisan group of former Chairmen, Commissioners and officials of the United States Securities and Exchange Commission (SEC), as well as prominent law and finance professors whose fields of academic inquiry include securities regulation, class-action practice, and law and economics. *Amici* have devoted substantial parts of their professional careers to implementing, drafting, and/or studying the federal securities laws, including how those laws should be interpreted to ensure the protection of investors and the promotion of efficiency, competition, and capital formation.

This brief reflects the consensus view of the *amici*, all of whom believe that the decision below should be affirmed. Each individual *amicus* may not endorse every argument presented herein, however. The former Chairmen, Commissioners, officials, and professors joining this brief as *amici*, listed alphabetically by category, are:

The Honorable Roderick M. Hills, who served as the Chairman of the SEC from 1975 through 1977.

The Honorable Harvey L. Pitt, who served as the Chairman of the SEC from 2001 through 2003, and who also served as General Counsel of the SEC from 1975 through 1978.

The Honorable Harold M. Williams, who served as the Chairman of the SEC from 1977 through 1981.

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[*] This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici* and their counsel contributed monetarily to the preparation or submission of this brief. *See* note 1, *infra*. The parties have consented to the filing of this brief and copies of their letters of consent have been lodged with the Clerk of the Court.

The Honorable Charles C. Cox, who served as a Commissioner of the SEC from 1983 through 1989, and as Chief Economist of the SEC from 1982 through 1983.

The Honorable Edward H. Fleischman, who served as a Commissioner of the SEC from 1986 through 1992.

The Honorable Stephen J. Friedman, who served as a Commissioner of the SEC from 1980 through 1981, and who is the President of Pace University.

The Honorable Joseph A. Grundfest, who served as a Commissioner of the SEC from 1985 through 1990, and who is the William A. Franke Professor of Law and Business and Co-Director of the Rock Center on Corporate Governance at Stanford Law School.[1]

The Honorable Isaac C. Hunt, Jr., who served as a Commissioner of the SEC from 1996 through 2001.

The Honorable Roberta S. Karmel, who served as a Commissioner of the SEC from 1977 through 1980, and who is the Centennial Professor of Law at Brooklyn Law School.

The Honorable Philip R. Lochner, Jr., who served as a Commissioner of the SEC from 1990 through 1991.

The Honorable Aulana L. Peters, who served as a Commissioner of the SEC from 1984 through 1988.

The Honorable Richard Y. Roberts, who served as a Commissioner of the SEC from 1990 through 1995.

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[1] Professor Grundfest has been retained by respondents to provide counsel in this matter. In that capacity he submitted a legal memorandum to the SEC that addressed some of the subjects addressed in this brief. Professor Grundfest was not, however, separately compensated in connection with the preparation of this brief.

The Honorable Laura S. Unger, who served as a Commissioner of the SEC from 1997 through 2002, and as Acting Chairman from February to August 2001.

The Honorable Steven Wallman, who served as a Commissioner of the SEC from 1994 through 1997.

James Doty, who served as General Counsel of the SEC from 1990 through 1992.

Simon M. Lorne, who served as General Counsel of the SEC from 1993 through 1996.

Professor Stephen M. Bainbridge, the William D. Warren Professor of Law at the University of California, Los Angeles, Law School.

Professor Stephen J. Choi, the Murray and Kathleen Bring Professor of Law, at New York University School of Law.

Professor Robert C. Clark, the Harvard University Distinguished Service Professor, Austin Wakeman Scott Professor of Law, and Former Dean at Harvard Law School.

Professor John C. Coates, the John. F. Cogan, Jr. Professor of Law and Economics at Harvard Law School.

Professor Richard A. Epstein, the James Parker Hall Distinguished Service Professor of Law and Director, the Law and Economics Program, at the University of Chicago Law School, and the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution.

Professor Allen Ferrell, the Greenfield Professor of Securities Law at Harvard Law School.

Professor Larry E. Ribstein, the Mildred Van Voorhis Jones Chair in Law at the University of Illinois College of Law.

Professor Richard W. Roll, Ph.D, Japan Alumni Professor of International Finance, at the Anderson Graduate School of Management, University of California, Los Angeles.

Professor Roberta Romano, the Oscar M. Ruebhausen Professor of Law and Director of the Center for the Study of Corporate Law at Yale Law School.

Professor Kenneth E. Scott, the Ralph M. Parsons Professor of Law and Business at Stanford Law School.

Professor Jeff Strnad, the Charles A. Beardsley Professor of Law at Stanford Law School.

INTRODUCTION AND SUMMARY OF ARGUMENT

Petitioner, a professional money management firm, invested in the common stock of Charter Communications, Inc. On behalf of a shareholder class, petitioner sued Charter for, *inter alia*, "entering into sham transactions with two equipment vendors that improperly inflated Charter's reported operating revenues and cash flow." *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 989 (8th Cir. 2006). Petitioner also sued the equipment vendors—respondents in this Court—for taking part in this "scheme." Petitioner alleged that respondents "entered into these sham transactions knowing that Charter intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations." *Id.* at 990. Respondents, however, "did not issue any misstatement relied on by the investing public, nor were they under any duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." *Id.* at 992.

In *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), this Court held that there is no liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), for "aiding and abetting" a fraudulent act—*i.e.*, only "primary" violators can be sued under that statute and its implementing regulation, Rule 10b-5, 17 C.F.R. § 240.10b-5. Congress quickly amended the Exchange Act to clarify that the SEC has enforcement authority over aiders and abettors, whom it defined as those

who "knowingly provide[] substantial assistance to another person in violation of [the Act]," 15 U.S.C. § 78t(e), but withheld that authority from private class-action plaintiffs. In this case, the lower courts correctly concluded that respondents are secondary actors subject to the enforcement authority of the SEC, but against whom there is no private right of action under the rule of *Central Bank*. *See* 443 F.3d at 992-93.

Petitioner's core contention is that respondents should have been categorized as primary violators under Section 10(b), and thus subject to liability in a private suit notwithstanding *Central Bank*, because they allegedly participated in a "scheme" to defraud Charter's shareholders. Although petitioner fails to articulate the contours of this theory of scheme liability, it apparently would encompass at least those entities that knowingly engage in "transactions with a public corporation . . . that enable[] the publication of artificially inflated financial statements by the public corporation," even though the entities themselves did not trade in the public company's stock, owed no duty to investors, and "made no public statements concerning those transactions." Pet. Br. i. *Amici* respectfully submit that knowingly "enabl[ing]" a public company's commission of an alleged fraud in this manner is a classic description of *secondary* liability. Accordingly, petitioner cannot maintain a class action against respondents under Section 10(b) and Rule 10b-5.

I. Both the text of Section 10(b) and the structure of the Exchange Act preclude judicial implication of a private right of action against a non-trading, non-speaking entity that merely "enables" the commission of an alleged fraud by a public company on its shareholders.

A. Petitioner's "scheme liability" theory is simply a semantic ploy designed to recast secondary conduct as a primary violation. The conduct at issue in *Central Bank* fits squarely within petitioner's definition of "scheme liability," but this Court has already held such conduct to be *secondary* to a primary violation and, thus, not actionable under Section 10(b). Mere knowing participation in another's alleged fraud

is not sufficient for liability to attach under that provision, as *Central Bank* makes clear, and petitioner has not alleged that respondents did anything more than that.

Following *Central Bank*, the SEC sought and received congressional clarification that it may proceed against persons, described as "aiders and abettors," who knowingly provide substantial assistance to a person who commits a primary violation. Petitioner's claim is that respondents knowingly provided substantial assistance to Charter, and thus respondents would be subject to the SEC's enforcement authority. But Congress did not confer equivalent authority on private plaintiffs; to the contrary, Congress has twice considered, but rejected, pleas to allow private claims against secondary actors. The Court should not do by fiat that which Congress has expressly declined to do by legislation.

B. No express provision in any of the federal securities laws allows investors to sue a non-speaking entity that did not transact in the issuer's securities and owed no duty to investors. Since Congress has never expressly authorized such a private suit, there is no reason to assume that Congress implicitly did so in Section 10(b). This Court has consistently resisted expansive readings of the judicially implied private right of action under Section 10(b). There is no warrant here to recognize a liability theory that Congress has not previously made available to private plaintiffs under the securities laws.

II. Policy considerations cannot override the text and structure of the Exchange Act unless they show that adherence to the statutory framework would lead to results so bizarre that Congress could not have intended them. The policy arguments advanced by petitioner and its *amici* fall far short of that standard.

A. Petitioner and its *amici* suggest that the private right of action under Rule 10b-5 ought to be extended to cover secondary actors to promote the policy goal of investor compensation. But there is a broad consensus in the academic community that the out-of-pocket measure of damages used

in Rule 10b-5 class actions challenging aftermarket fraud is economically irrational, because it bears little relation to the actual net harm suffered by investors. The wisdom of extending the current Rule 10b-5 remedial scheme is therefore far from obvious, particularly since the money paid to settle Rule 10b-5 class actions is most often funded by other innocent investors (and at considerable transaction costs). Furthermore, the SEC can now itself provide investors with meaningful compensation pursuant to its authority under the "Fair Funds" provision in the Sarbanes-Oxley Act of 2002.

B. The deterrence justification for judicially implying a private right of action premised on "scheme liability" is also dubious, since substantial deterrents already exist. The SEC and Department of Justice already can pursue claims against aiders and abettors, and none of the briefs submitted by petitioner and its *amici* demonstrates that additional deterrence is necessary or appropriate at the margins. Moreover, private "scheme liability" would give rise to substantial costs that might exceed its questionable deterrent benefits. Because the concept of "scheme liability" is not susceptible of precise definition, defendants faced with scheme liability claims may feel compelled to settle rather than risk expensive and protracted litigation. In addition, a defendant charged with scheme liability often will face damages exposure greatly in excess of the value of the transaction alleged to be part of the scheme. The risk of such liability would factor into the price of such transactions *ex ante*, raising the costs of doing business for companies listed on the U.S. markets. It could also stifle innovation in derivative transactions and other financial products.

III. Whether to create a new private right of action—or to extend an existing one—is a question appropriately directed to Congress, not this Court. Congress thus far has seen fit to give the SEC authority to pursue those who provide substantial assistance to primary violators of the securities laws, while withholding similar authority from private plaintiffs. If Congress were to consider expanding the private right, it would have to take into account a number of

competing policy considerations, including the impact of such an expansion on efficiency, competition and capital formation. It would also have to consider the proper parameters of scheme liability, including whether to provide safe harbors for derivative or other transactions. At the end of the legislative process, Congress might decide—as it has twice before—that the marginal costs of extending the private right to cover secondary actors would exceed the marginal benefits of such an extension, or it might decide that such an extension is warranted. But the very fact that a legislature could reasonably reach either conclusion demonstrates that the decision is not one for the Judiciary in the first instance.

ARGUMENT

Recognition of a private cause of action under Section 10(b) against non-trading, non-speaking entities that allegedly do no more than knowingly "enable[]" fraud by a public company (Pet. Br. i) is precluded by the text and structure of the Exchange Act. The policy arguments advanced by petitioner and its *amici* do not warrant deviation from that text and structure; to the contrary, considerations of legal and economic policy cast considerable doubt on the wisdom of allowing private suits like petitioner's. Those doubts should be resolved by Congress, not this Court.

I. The Text And Structure Of The Exchange Act Preclude Imposition Of Scheme Liability In Private Rule 10b-5 Actions

To determine whether a private plaintiff's claim may proceed under Rule 10b-5, this Court has employed a two-step statutory analysis. *First*, "the text of the statute controls" with respect to the "conduct prohibited by § 10(b)." *Central Bank*, 511 U.S. at 173. *Second*, "[w]hen the text of § 10(b) does not resolve a particular issue, [the Court] attempt[s] to infer how the 1934 Congress would have addressed the issue." *Id.* at 178 (internal quotation marks omitted). Both steps of the statutory analysis compel affirmance in this case.

A. Scheme Liability Is Inconsistent With Section 10(b), As Construed In *Central Bank*

Petitioner's attempt to hold non-trading, non-speaking entities such as respondents liable in an implied private action under Section 10(b) founders on the language of the statute itself. The analysis in this regard can be boiled down to two incontrovertible events: This Court's decision in *Central Bank*, and the congressional response to that decision.

1. Central Bank served as indenture trustee for bonds issued subject to a covenant that they be secured by real estate worth at least 160% of the bonds' outstanding principal and interest. *Central Bank*, 511 U.S. at 167. The bank was "aware of concerns" regarding the value of the security, in particular "the accuracy of the [pre-existing] appraisal." *Id.* at 168. A senior underwriter of the bond warned the bank that the appraisal, which was then more than 16 months old, "'should be suspect and not relied on'" in light of declining real-estate values. *First Interstate Bank of Denver, N.A.* v. *Pring*, 969 F.2d 891, 894 n.5 (10th Cir. 1992). And the bank's own in-house appraiser expressed concern about the values used in the appraisal. 511 U.S. at 167. Despite these warnings, Central Bank acceded to the bond issuer's request to delay an independent appraisal by six months, during which time the issuer defaulted on a new issuance that, the plaintiff alleged, would not have come to market absent Central Bank's agreement to defer the new appraisal. *Id.* at 167-68.

This Court concluded that Central Bank's conduct was beyond the proscriptive reach of Section 10(b). Central Bank, itself, "did not commit a manipulative or deceptive act within the meaning of § 10(b)," as the plaintiffs there had to concede. 511 U.S. at 191. Instead, Central Bank would have had to be found "'secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud'" committed by the issuer. *Ibid.* This Court concluded, however, that Section 10(b) reaches only *primary* violators. *Ibid.* It therefore held that the suit against Central Bank had properly been dismissed by the district court. *Id.* at 191-92.

As a comparison with the facts of *Central Bank* makes clear, petitioner's "scheme liability" theory is simply a semantic ploy designed to recast secondary conduct as a primary violation. The conduct at issue in *Central Bank* would fit *squarely* within the definition of "scheme liability" that petitioner proposes in this case (Pet. Br. i): Central Bank engaged in a transaction with the issuer (*i.e.*, an agreement to defer the new appraisal) that "enabled" the issuer to publish false statements (*i.e.*, that the security covenant was satisfied), although the bank itself made no statement directly to the bondholders. It follows *a fortiori* from *Central Bank* that respondents here, who owed no duty to Charter's shareholders and did not engage in any public misrepresentations (or public deceptive acts), also did not engage in a primary violation (regardless of whether they "enable[d]" Charter's allegedly fraudulent scheme). *See Chiarella* v. *United States*, 445 U.S. 222, 233 (1980) (declining, in the absence of "explicit evidence of congressional intent," to "recogniz[e] a general duty between all participants in the market" to refrain from any act that may contribute to harm to other market participants).

Indeed, one of the central elements of the implied private Rule 10b-5 action is the plaintiff's *reliance* on the defendant's alleged wrongdoing. *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 341 (2005). But petitioner, the plaintiff here, cannot establish reliance on respondents' alleged wrongdoing, either directly or by use of the fraud-on-the-market presumption: Again, respondents made *no* public misrepresentations and engaged in *no* public deceptive acts (*cf. Basic Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988)); moreover, given their lack of duty, respondents cannot be charged with an actionable omission (*cf. Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972)). Allowing a defendant to be held "liable without any showing that the plaintiff relied upon [defendant's] *statements* or *actions*" would "circumvent the reliance requirement [and] would disregard the careful limits on 10b-5 recovery mandated by . . . earlier cases." *Central Bank*, 511 U.S. at 180 (emphasis added); *see also id.* at 191 (describing a primarily liable party as one "who employs a

manipulative device or makes a material misstatement (or omission) *on which a purchaser or seller of securities relies*") (emphasis added); *cf.* Roberta S. Karmel, *When Should Investor Reliance Be Presumed In Securities Class Actions?*, Brooklyn Law School Legal Studies Research Papers: Accepted Papers Series, Research Paper No. 80 at 39 (forthcoming in BUSINESS LAWYER 2007), *available at* http://ssrn.com/abstract=1001743 (observing that "extending the fraud-on-the-market doctrine to statements by third parties, who are not required to speak by SEC regulations, or do not owe a duty to investors or shareholders" would be unwise, as it could "encourage too much questionable litigation").

As the Court put it in *Central Bank*, "[t]he proscription" of Section 10(b) "does not include giving aid to a person who commits a manipulative or deceptive act." 511 U.S. at 177. *Central Bank* itself recognized that knowing participation in a "scheme" is simply another label for aiding and abetting when it analogized an aiding-and-abetting claim under the securities laws to a claim for "knowing *participation* in a breach of fiduciary duty" under ERISA, and the Court rejected both under the text of the applicable statutes. *Id.* at 175, 176 (emphasis added); *see also* Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 105-06 & n. 138 (1981) (arguing that knowingly assisting another's deceptive act does not violate Section 10(b)). Petitioner has not alleged that respondents did anything more than knowingly participate *in Charter's* alleged fraud; this is a secondary violation in every sense of the word.[2]

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[2] Contrary to the suggestion of petitioner's amici (Br. for Charles W. Adams, et al. 3), interpreting the scope of Section 10(b) in accordance with its text would not allow the villain Fagin, from *Oliver Twist*, to escape liability under the Ex-

[Footnote continued on next page]

2. In the wake of *Central Bank*, the SEC lobbied Congress for clarification that it may pursue secondary actors. Congress responded not by amending Section 10(b), but by enacting a new Section 20(e), which provides:

> **Prosecutions of Persons Who Aid and Abet Violations**. For purposes of any action brought by the Commission . . . , any person that *knowingly provides substantial assistance* to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

15 U.S.C. § 78t(e) (emphasis added).

Thus, if there were any question after *Central Bank* that aiding and abetting liability includes "scheme liability," Congress laid it to rest by *defining* aiding and abetting liability, for purposes of SEC enforcement actions, to include precisely that: Petitioner's claim, at bottom, is that respondents *knowingly provided substantial assistance* to Charter's alleged fraud. But Congress consciously decided, both when it enacted Section 20(e) in 1995 and again when it enacted Sarbanes-Oxley in 2002—*not* to extend the right to enforce this liability to private plaintiffs. *See* S. Rep. No. 104-98, at 48 (1995) ("The Committee believes that amending the 1934 Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to S. 240's goal of reducing meritless securities litigation"); H.R. Rep. No. 107-414, at 54 (2002); 148 Cong. Rec. S6584 (daily ed. July 10, 2002). This Court should not do, by fiat, that

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[Footnote continued from previous page]

change Act. *See* 15 U.S.C. § 78t(a) (imposing control person liability).

which the Congress has declined to do each time it has been presented with the issue.

B. No Express Private Right Of Action Recognizes Scheme Liability

Central Bank and the congressional reaction to that decision make clear enough that Section 10(b) does not encompass scheme liability. The express private rights of action that Congress chose to include in the Exchange Act only serve to confirm that conclusion. No express provision in any of the federal securities laws allows investors to sue a non-speaking entity that did not transact in the issuer's securities and owed no duty to investors. Since Congress has never expressly endorsed petitioner's theory of "scheme liability," it makes no sense to assume that Congress implicitly did so for private Rule 10b-5 actions.[3]

The Court's conclusion in *Central Bank* is equally applicable here: "From the fact that Congress did not attach private aiding and abetting liability to any of the express causes of action in the securities Acts, we can infer that Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action." 511 U.S. at 179. By parity of reasoning, the fact that Congress has never seen fit to allow a private action premised on "scheme liability" compels the inference that Congress would not have authorized such liability in private Rule 10b-5 actions. That inference is confirmed by the post-*Central Bank* actions (and inactions) by Congress described in the preceding section.

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[3] This is not to suggest that an entity that does speak, breach a duty or transact in the issuer's securities is necessarily liable under Rule 10b-5. *See Dura Pharms., Inc.*, 544 U.S. at 341 (listing the elements necessary to establish a private Rule 10b-5 claim).

The implied right of action under Rule 10b-5 is of judicial creation. This Court has repeatedly resisted expansive readings of the implied right, recognizing that private securities litigation is susceptible to abuse. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 736 (1975) ("It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action"); *Dura*, 544 U.S. at 347 (rejecting plaintiffs' claim that loss causation need not be alleged with specificity based on concerns about "'abusive' practices"). There is simply no warrant for the Court to adopt, or invent, a liability theory that Congress has never expressly afforded to private plaintiffs under the federal securities laws. *Cf.* David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision Of Legislative Intent?*, 57 NW. U. L. REV. 627, 660 (1962) (because it is implied, the private right under Rule 10b-5 "should be interpreted with caution").

II. The Policy Arguments Advanced By Petitioner And Its *Amici* Do Not Justify Deviation From The Text And Structure Of The Exchange Act

Petitioner and some of its *amici* suggest that private Rule 10b-5 liability ought to be extended to encompass "scheme liability" in order to ensure investor compensation and adequate deterrence. But such "[p]olicy considerations cannot override [this Court's] interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." *Central Bank*, 511 U.S. at 188. The arguments advanced by petitioner and its *amici* fall far short of that standard.

A. Compensation

Petitioner and its *amici* urge this Court to characterize those who merely "enable" another's fraud as primary violators in order to promote the goal of investor compensation. But a broad consensus in the academic community recognizes that the out-of-pocket measure of damages utilized in

Rule 10b-5 class actions challenging aftermarket fraud is economically irrational. Innocent investors, rather than the actual wrongdoers, most often fund the recovery in Rule 10b-5 class actions. Given that diversified investors are unlikely, over time, to suffer net harm from aftermarket securities fraud, this very expensive system of investor self-insurance is difficult to defend from a compensatory standpoint. The wisdom of extending it to cover "scheme liability" claims is therefore far from obvious.

1. Almost without exception, Rule 10b-5 class actions that are not dismissed at the pleading stage result in settlement, and the individual wrongdoers allegedly responsible for the fraud rarely contribute. *See* John C. Coffee, Jr., *Reforming The Securities Class Action: An Essay On Deterrence And Its Implementation*, 106 COLUM. L. REV. 1534, 1550-51 (2006). Instead, the primary sources of settlement payments are issuers, their insurers, and ancillary defendants. *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1506 & n. 81 (1996). Each of these sources of funds may be traced back to innocent investors: Payments by the issuer effect a direct transfer of wealth from the issuer's current shareholders to the class members; payments by insurers are funded by premiums paid by the insurer's policyholders (issuers and, indirectly, their innocent shareholders); and payments by ancillary defendants, like accountants and investment banks, may be charged back to issuers (and, indirectly, their innocent shareholders) through increased fees due to litigation risk. *See* Donald C. Langevoort, *Capping Damages For Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 649 (1996). Moreover, ancillary defendants may themselves be publicly-owned companies, thus implicating yet another group of innocent investors.

As a result, the amount that some investors gain from private Rule 10b-5 class actions "will show up on the other side of the capital marketplace ledger as roughly an equal charge to other[]" innocent investors. Langevoort, 38 ARIZ. L. REV. at 649. Rule 10b-5 class actions are therefore like a

very inefficient form of investor self-insurance—one that, as explained below, diversified investors do not need. *See* INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at 79 (2006) (the transfer from diversified investors to other diversified investors "represents a pocket-shifting wealth transfer that compensates no one in any meaningful sense and that incurs substantial wasteful transaction costs in the process").

2. The loss suffered by an investor who purchased securities at an artificially inflated price is always matched with a corresponding gain to the investor on the other side of the transaction—thus, in a case of aftermarket fraud, innocent investors earn a profit by selling their stock at a price inflated by the fraud, and the law allows them to keep their profits. Because it can be assumed that an innocent investor's chance of being on the losing or winning side of such a transaction is random, a well-diversified investor's gains and losses from aftermarket securities fraud will tend to net out over time.[4]

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[4] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339-341 (1991); Richard A. Epstein, CASES AND MATERIALS ON TORTS, 8th edition, 1124 n.4 (Aspen 2004); Stephen J. Choi & A.C. Pritchard, SECURITIES REGULATION: CASES AND ANALYSIS at 348 (2005); James D. Cox, Robert W. Hillman, & Donald C. Langevoort, SECURITIES REGULATION: CASES AND MATERIALS 727-728 (5th ed. 2006); Larry E. Ribstein, *Dabit, Preemption and Choice of Law*, 2006 CATO SUPREME COURT REVIEW 141, 147-152; Richard A. Booth, *Who Should Recover What For Securities Fraud?*, University of Maryland School of Law Legal Studies Research Paper, No. 2005-32 (2005) at 6, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=683197; Anjan V. Thakor, *The Economic Reality of Securities Class Action Litigation* at 1 (Navigant Consulting 2005), *available at* http://downloads.heartland.org/18331.pdf; Janet Cooper Alexander, *Rethinking*

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Such an investor would "perceive[] little good in a legal rule that forces his winning self to compensate his losing self over and over," while paying substantial legal fees to boot. Easterbrook & Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 340; *see also* Coffee, 106 COLUM. L. REV. at 1537 (observing that "the burden of securities [litigation] falls perversely on the victim," which may explain "stock price event studies that report that the subject company's stock price typically falls when a securities class action is filed and that stock prices generally rise when legislation is passed curtailing securities class actions"); Alexander, 48 STAN. L. REV. at 1502 ("the risk of litigation, unlike the risk of securities fraud, cannot be diversified against because the legal fees of both sides constitute a deadweight loss").

This is not to say that aftermarket securities fraud causes no harm to investors. But extending the remedy of out-of-pocket compensatory damages to reach secondary violators in aftermarket fraud cases, such as this one, is not the best method for redressing that harm. *Cf.* Langevoort, 38 ARIZ. L. REV. at 651 (the compensatory justification for private Rule 10b-5 actions "has relatively few informed, non self-serving defenders"); Coffee, 106 COLUM. L. REV. at 1545 ("From a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly"); A.C. Pritchard, *Who Cares?*, 80 WASH. U. L.Q. 883, 884 (2002) ("Securities class actions cannot be justified as providing compensation"). This is particularly true now that the SEC is authorized to play an important role in providing compensation to investors through the "Fair Funds" provision in the Sarbanes-Oxley Act of 2002. *See infra* at 18.

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Damages in Securities Class Actions, 48 STAN. L. REV. 1487, 1495-1496 (1996).

B. Deterrence

The deterrence-based policy arguments raised by petitioner and its *amici* similarly fail to demonstrate that adhering to the text and structure of the Exchange Act would lead to a "'bizarre'" result. *Central Bank*, 511 U.S. at 188. Those who assist another's primary violation of Rule 10b-5 *already* face significant sanctions at the hands of public enforcers; it is therefore far from clear whether the additional marginal deterrence that might result if private "scheme liability" were recognized is even necessary. Nor is it clear whether the benefits of this additional deterrence, if any, would exceed the costs of expanding the scope of the implied right.

1. Those who aid and abet securities law violations face considerable deterrents under the existing regime. The Department of Justice, for example, can bring criminal charges against those who aid and abet a securities law violation. *See* 18 U.S.C. § 2. As noted above, Congress has also conferred authority on the SEC to pursue aiders and abettors, 15 U.S.C. § 78t(e)—authority the SEC has utilized to pursue allegations *identical to those in this case*. *See* SEC Release No. 19735, SEC v. Scientific-Atlanta, Inc., Civ. Action No. 06 Civ. 4823 (PKC) (June 22, 2006), *available at* http://www.sec.gov-/litigation/litreleases/2006/lr19735.htm; *see also* PRICEWATERHOUSECOOPERS LLP 2006 SECURITIES LITIGATION STUDY at 24-25, *available at* http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf (detailing public enforcement efforts in 2006).

The SEC has utilized its enforcement authority in recent years to recover substantial penalties from securities law violators, money it has returned in large part to injured investors pursuant to the Fair Funds provision in the Sarbanes-Oxley Act of 2002. 15 U.S.C. § 7246; *see also* 17 C.F.R. §§ 201.1100-201.1106. Indeed, the SEC has collected at least $8 billion for distribution to harmed investors since 2002. *See* 2006 PERFORMANCE AND ACCOUNTABILITY REPORT, U.S. Securities and Exchange Commission, *available at* http://www.sec.gov/about/secpar/secpar2006.pdf. It recently reported that it has returned over $1 billion to inves-

tors since 2005. *See Hearing: A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission Before the House Comm. on Financial Services*, 110th Cong., 1st Session (June 26, 2007) (Statement of the Securities and Exchange Commission) (noting that "[s]everal additional large disbursements are pending and will be announced shortly").

In addition to financial penalties, the SEC has available to it a panoply of remedies that enable it to perform its deterrent function in a finely calibrated manner, depending on the facts and circumstances of the particular case before it. These remedies, the availability of which vary somewhat depending on whether the Commission initiates an administrative proceeding or files suit directly in federal court, today include: officer and director bars; injunctive relief; cease and desist orders; disgorgement of ill-gotten gains; and orders requiring corrective disclosures and corporate governance changes, among other things. *See* Vincent J. Badolato, SECURITIES LAW TECHNIQUES §§ 87.06-87.07 (Matthew Bender 2006). Importantly, the SEC and DOJ can impose career- and liberty-ending sanctions on individuals involved in fraudulent activity. Public enforcement serves as a stronger deterrent in this regard than private enforcement, as individuals are rarely made to contribute to the settlement of Rule 10b-5 class actions. *See* Coffee, 106 COLUM. L. REV. at 1550-51.[5]

In light of the amount of deterrence that already exists, it is far from clear that the additional *marginal* deterrence that might result from implying private "scheme liability" is even necessary. *See* INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at 78 ("the public value of

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[5] The Sarbanes-Oxley Act of 2002 further protects against fraud by, *inter alia*, imposing potential civil and criminal liability for the false certification of the adequacy of internal controls. *See* 15 U.S.C. § 7241; 18 U.S.C. § 1350.

the securities class action is questionable"). Nor, as discussed below, is it clearly desirable. *Cf.* Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1642 (2006) ("Auditors now face enhanced vulnerability to liability risks that—at least according to some—threaten the very viability of the industry as we know it").

2. It is not clear that the potential marginal benefits of Rule 10b-5 "scheme liability" class actions would exceed their marginal costs, and petitioner and its *amici* have made no such showing. More enforcement is not an unmitigated good. To the contrary, "[i]f there is excessive securities litigation, too many resources will be spent on litigation and on litigation avoidance. The cost of capital will then increase just as if a wasteful tax had been imposed on capital formation." Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 732 (1995) (emphasis omitted). When liability rules are unclear, the risk of overenforcement, and overdeterrence, is particularly acute. In recognition of this, the bipartisan Committee on Capital Markets Regulation recently advised that "there needs to be greater clarity to private litigation under Rule 10b-5." INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at xii. It recommended that the SEC provide more guidance on such things as materiality, scienter, and reliance, to help ensure that the U.S. capital markets stay competitive in the global economy. *Id.* at 80-82.

Were this Court to recognize petitioner's theory of "scheme liability," it would inject confusion, not clarity, into private litigation under Rule 10b-5. Not even proponents of "scheme liability" can consistently define this amorphous concept.[6] Given this uncertainty, and the magnitude of the

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[6] Compare Br. of the SEC at 18, *Simpson* v. *AOL Time Warner, Inc.*, No. 04-55665 (9th Cir. Oct. 22, 2004) (defendant must "engag[e] in a transaction whose principal purpose

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potential damage awards, defendants in private Rule 10b-5 "scheme liability" cases might "find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Central Bank*, 511 U.S. at 189.

Those involved in derivative securities transactions might face a particularly strong pressure to settle, given that such transactions commonly raise complex accounting, taxation, and reporting issues. In light of these complexities, there exists a material probability that courts would allow class action fraud claims predicated on derivative markets transactions to move past the motion to dismiss stage, even though the impropriety of the transaction may be subject to considerable doubt—transactions that seem entirely legal to one impartial fact-finder may seem problematic to another fact-finder considering precisely the same facts. *See gener-*

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and effect is to create a false appearance of revenues") with *Simpson* v. *AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), *petition for cert. filed* (Oct. 19, 2006) (No. 06-560) ("defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme"; rejecting SEC's suggestion that it is sufficient "that a *transaction* in which a defendant was involved had a deceptive purpose and effect") (emphasis in original); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 502-04 (S.D.N.Y. 2005) (defendant must have "directly or indirectly used or employed any device or contrivance with the capacity or tendency to deceive"; rejecting *Lernout's* requirement of "substantial participation" as inconsistent with Section 10(b)'s text); and *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) (defendant must have "substantially participate[d] in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device . . . intended to mislead investors").

ally Joseph A. Grundfest, *Scheme Liability: A Question for Congress, Not for the Courts*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005524 at 14-15.

In this regard, it is illustrative to compare the British High Court's decision in *Mahonia Limited* v. *JP Morgan Chase Bank, West LB AG*, 2004 WL 1808816 (Q.B.D. (Comm. Ct.)) (Aug. 3, 2004), with the Commission's enforcement action in *SEC* v. *J.P. Morgan Chase & Co.*, No. H-03-28-77 (S.D. Tex.). Both actions involved a series of complex derivative transactions called "prepays." The SEC alleged that these transactions "had no business purpose aside from masking the fact that, in substance, they were loans and not swap contracts," and should therefore have been accounted for as loans. *J.P. Morgan* Compl. ¶1. The swap counterparty (Chase) was alleged by the SEC to be liable as an aider and abettor to securities fraud.[7] In stark contrast, the British High Court, having considered precisely the same transactions, concluded (at ¶236) that the "accounting for the prepays was not in breach of US GAAP [and] that its accounting for these transactions did not constitute a breach of US securities law." The British High Court further concluded that "[e]ven if there had been a breach of US GAAP," it "would not have found that there was any aiding and abetting by Chase." *Id.* ¶240. Evidently, objective observers of good faith can have differing views regarding the proper accounting for a derivative markets transaction.

In addition to prompting defendants to settle defensible cases and incentivizing plaintiffs to file questionable claims, recognizing private "scheme liability" would give rise to other costs. "Scheme liability" would expose those engaging in commercial transactions with public companies to disproportionate damages orders of magnitude greater than the size of the transaction alleged to give rise to the liability, and for

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[7] Chase settled the matter with the SEC, without admitting or denying the allegations in the complaint.

misstatements or omissions that they, themselves, did not make.[8] This would encourage such parties to spend resources monitoring the adequacy of their public counterparty's disclosures. These additional costs and the residual risk of liability would likely be priced into those transactions *ex ante*, burdening companies listed on the U.S. markets—and, ultimately, their investors and customers.

Start-up and technology companies might feel the brunt of these increased costs in their dealings with suppliers and creditors, given that their volatile stock prices make them—and those who deal with them—the most likely targets of securities fraud class actions. Moreover, innovation in the financial services area might be stifled for fear that new types of transactions would be labeled as "deceptive," and subject a financial institution to huge liabilities. Indeed, if "scheme liability" were recognized, particularly without transactional safe harbor provisions of the sort that could be created only by Congress, the implications for derivative trading, and its continued presence in U.S. markets subject to U.S. prosecution, may be profound. It is not obvious that the additional monitoring of public company disclosures that scheme liability might prompt would create benefits in excess of these costs.

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[8] In this case, for example, the total market capitalization loss upon disclosure of a criminal investigation into Charter's practices was $7 billion. The amount of alleged inflation attributable to respondents' transactions with Charter, by contrast, was only $17 million. *See also* Second Am. Consol. Class Action Compl. ¶¶ 9, 25, *In re Fannie Mae Sec. Litig.*, MDL No. 1688 (D.D.C.) (alleging that Goldman Sachs violated Rule 10b-5(a) and (c) by "engineering" two transactions that Fannie Mae purportedly accounted for erroneously, and seeking to hold Goldman Sachs liable for Fannie Mae's $12 billion loss of market capitalization even though its involvement affected less than 1% of the alleged stock price inflation).

This Court recognized the potential for these types of "ripple effects" in *Central Bank*. 511 U.S. at 189. It explained that interpreting Section 10(b) to encompass aiding and abetting liability would "exact[] costs that may disserve the goals of fair dealing and efficiency in the securities markets." *Id.* at 188. The Court declined to do so, based in part on the fact that "the rules for determining aiding and abetting liability are unclear, in 'an area that demands certainty and predictability.'" *Ibid.* Uncertain risk of liability might cause securities professionals to refuse to provide services to some companies altogether, this Court explained, and might cause them to increase the prices charged to others (prices "in turn [paid] by the company's investors, the intended beneficiaries of the statute"). *Id.* at 189.

A similar sentiment influenced this Court's recent decision in *Credit Suisse Securities (USA) LLC* v. *Billing*, 127 S. Ct. 2383 (2007). The Court took as a given that the conduct alleged in that case had been disapproved by the SEC, but nonetheless observed that serious harm could come of subjecting that conduct to private attack under the antitrust laws. The Court explained that "only a fine, complex, detailed line separates activity" that the SEC permits and forbids, and that "[i]n light of the nuanced nature of the evidentiary evaluations necessary to separate the permissible from the impermissible, it will prove difficult for . . . different courts to reach consistent results." *Id.* at 2394, 2395. Thus, allowing private antitrust suits to proceed would likely "overly deter syndicate practices important in the marketing of new issues." *Id.* at 2397. Decisions such as *Central Bank* and *Billing* confirm the wisdom of leaving the difficult policy question whether to expand the private right of action under Rule 10b-5 to include "scheme liability" to Congress.

III. Creating A Private Right Of Action Is A Job For Congress, Not This Court

The days of judicially-implied private rights of action are long past. *Alexander* v. *Sandoval*, 532 U.S. 275, 287 (2001); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 18-19 (1979). Under the modern regime, the deci-

sion to create a new cause of action—or, equivalently, to extend an existing right of action—lies squarely with Congress, not the courts. *Sandoval*, 532 U.S. at 288. This Court recently reiterated as much in the context of the very statute at issue in this case. *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, No. 06-484, 551 U.S. __, slip op. at 15-16 (June 21, 2007) ("It is the federal lawmaker's prerogative . . . to allow, disallow, or shape the contours of—including the pleading and proof requirements for—§ 10(b) private actions"). Congress chose to leave it to the SEC alone to enforce scheme liability. If petitioner and its *amici* believe that an expansion of private securities litigation is advisable—in light of the changes wrought by the PSLRA, or to better incentivize gatekeepers to police for fraud, or for any of the other various policy reasons set forth in the briefs in this case—they should direct their proposals to Congress, not this Court.

In deciding whether to create a private right of action premised on "scheme liability," Congress would have to determine whether the marginal benefits of doing so would exceed the marginal costs. As explained above, that would require the weighing of several difficult policy considerations. To aid in that process, Congress could hear witnesses, request studies, and otherwise examine the empirical evidence to predict the likely consequences of recognizing scheme liability for capital formation, market efficiency, and consumer welfare. If nothing else, the process would make a record that would assist the Court in construing any resulting legislation. *Cf. Tellabs*, 551 U.S. __, slip op. at 10 (noting PSLRA's "twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims").

Congress would also have to consider how "scheme liability" should be defined, something neither the SEC (in its enforcement capacity) nor the lower courts have been able to agree on. *See* note 6, *supra*. It might also consider whether to offer certain safe harbors to ensure that beneficial derivative transactions meant to hedge risks for investors are not unnecessarily deterred. *See generally* Grundfest, *Scheme Li-*

ability: A Question for Congress, Not for the Courts, *supra*, at 6-7. Or it might simply extend the Commission's existing power under Section 20(e) to private plaintiffs. Of course, that Congress has thus far chosen *not* to do so only reinforces the wisdom of leaving this decision to Congress in the first instance.

A responsible legislature would weigh these and similar policy considerations before deciding to expand the private right of action under Rule 10b-5 to encompass non-trading, non-speaking entities such as respondents. *See, e.g.*, S. Rep. No. 104-98, at 48 (noting risks of meritless litigation raised by private aiding-and-abetting liability). It could be that, at the end of the legislative process, Congress would make the political judgment that the benefits of a private "scheme liability" regime would outweigh its costs. It could also be, however, that Congress would determine that the marginal benefits of recognizing private scheme liability, if any, are far outweighed by the costs of such liability. The very fact that the legislature could reasonably come out on either side of this policy debate—a point that petitioner cannot dispute—is sufficient to demonstrate that it is, at bottom, a legislative decision, not a judicial one.

Most lower courts have properly recognized the limitations on the Judiciary's power to create or extend private rights of action, and thus have refused to recognize "scheme liability."[9] This majority view reflects a general consensus among federal judges that, if scheme liability is to be recog-

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[9] *Charter*, 443 F.3d at 989; *Regents of the Univ. of Cal.* v. *Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *petition for cert. filed* (Apr. 5, 2007) (No. 06-1341); *Fidel* v. *Farley*, 392 F.3d 220, 235 (6th Cir. 2004); *Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1213 (11th Cir. 2001); *Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter* v. *Home-Stake Prods. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996).

nized at all, it should be done in the first instance by Congress: Imposing liability for securities fraud based on transactions "in goods or services other than securities . . . would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress." *Charter*, 443 F.3d at 992-93.

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It has been observed that "[t]his is one of the most important securities cases to be heard by this Court in many years." Br. for William H. Donaldson, et al. 2. On this point, *amici* joining this brief are in agreement. This *is* an important case. It is important because it gives the Court the opportunity to reconfirm that the securities laws mean what they say, *Tellabs*, 551 U.S. __, slip op. at 12; that the securities laws should be construed to further market efficiency, *Billing*, 127 S. Ct. at 2396; and that pure policy decisions are for Congress in the first instance, *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976). The Court's decision in *Central Bank* reflects each of those principles. Adherence to them requires affirmance of the judgment below. Departure, by contrast, would "re-open a plethora of doctrinal issues regarding the interpretation of the federal securities laws that are today clearly resolved." Grundfest, *Scheme Liability: A Question for Congress, Not for the Courts*, *supra*, at 3-4.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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